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No. 06-1413

IN THE

Supreme Court of the United States

MEADWESTVACO CORPORATION,
Successor in Interest to THE MEAD CORPORATION,
Petitioner,

v.

ILLINOIS DEPARTMENT OF REVENUE,
DIRECTOR OF THE ILLINOIS DEPARTMENT OF REVENUE,
AND TREASURER OF THE STATE OF ILLINOIS,
Respondent.

On Writ of Certiorari to the Illinois Appellate Court

BRIEF OF TAX EXECUTIVES INSTITUTE, INC. AS *AMICUS CURIAE* SUPPORTING REVERSAL

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UNIFORM LAWS

Uniform Division of Income for Tax Purposes Act 8

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BRIEF OF TAX EXECUTIVES INSTITUTE, INC. AS *AMICUS CURIAE* SUPPORTING REVERSAL

INTEREST OF *AMICUS CURIAE*

Pursuant to Rule 37 of the Rules of this Court, Tax Executives Institute, Inc. respectfully submits this brief as *amicus curiae*.[1] Tax Executives Institute

[1] Pursuant to Rule 37.6, *amicus* Tax Executives Institute, Inc. states that no counsel for a party has written this brief in whole or in part and that no person or entity, other than *amicus*, its members, or its counsel, has made a monetary contribution to the preparation or submission of this brief. Both parties have consented to the filing of this *amicus* brief.

(hereinafter "TEI" or "the Institute") is a voluntary, non-profit association of corporate and other business executives, managers, and administrators who are responsible for the tax affairs of their employers. TEI was organized in 1944 under the laws of the State of New York and is exempt from taxation under section 501(c) (6) of the Internal Revenue Code of 1986 (26 U.S.C.). The Institute is dedicated to promoting the uniform and equitable enforcement of the tax laws, reducing the costs and burdens of administration and compliance to the benefit of both the government and taxpayers, and vindicating the Commerce Clause and other constitutional rights of business taxpayers.

TEI has approximately 7,000 members who represent more than 3,000 of the leading corporations in the United States, Canada, Europe, and Asia. TEI's members represent a cross-section of the business community whose employers are, almost without exception, engaged in interstate commerce. Therefore, TEI's members have a keen interest in this case, which involves the constitutional limits on the States' ability to impose tax on a nondomiciliary taxpayer's income that bears no connection to the taxpayer's in-state activities.

The multijurisdictional companies represented by the Institute's membership are directly and materially affected by the rules governing allocation and apportionment of income among the various States. If the decision of the Appellate Court of Illinois is allowed to stand, then not only will Petitioner MeadWestvaco Corporation (hereinafter "Mead") be denied the protections of the Commerce and Due Process Clauses, but the vitality of the Court's holding in *Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768 (1992), will be undermined and tax-

payers throughout the Nation will suffer from the resulting uncertainty, the increase in the cost and burden of compliance, and the enhanced potential for duplicative taxation. As the professionals who must contend daily with the interpretation and administration of the Nation's tax laws, the Institute's members have a vital interest in the proper disposition of this case.

SUMMARY OF ARGUMENT

The State of Illinois has erroneously sought to tax the gain realized by MeadWestvaco Corporation ("Mead") upon its disposition of Lexis/Nexis, a nonunitary, nondomiciliary company it held for investment. In sustaining the State's attempt to tax that gain, the Illinois Appellate Court vitiated the Court's holding in *Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768 (1992), which held that a State may not tax the income of a nondomiciliary corporation if the income is derived from business activities that constitute a distinct business enterprise with business operations unrelated to the business carried on in the State.

Under the Commerce and Due Process Clauses of the Constitution, taxation by a State of the out-of-state income of a domiciliary corporation requires a connection between the interstate activities of the enterprise and the taxing State and a rational relationship between the income attributed to the State, from the interstate activity, and the intrastate values of the enterprise. *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 445 U.S. 425, 436-37 (1980). And, while this Court has permitted apportionment of income even in the absence of a unitary business relationship, it has done so only

when the asset in question serves an operational rather than an investment function. Here, Lexis/Nexis possessed neither the requisite link with Illinois nor did it serve an operational function to Mead's unitary business in the State of Illinois. Nevertheless, the Appellate Court in Illinois misapprehended this Court's teaching in *Allied-Signal*, holding the gain to be taxable in Illinois.

Lexis/Nexis and Mead were separate and distinct businesses, exhibiting neither functional integration, centralization of management, nor economies of scale—the three attributes that have been focus of the Court's unitary analysis. Moreover, their relationship possesses none of the external or internal indicia that are hallmarks of an operational relationship. These criteria transcend the sometimes artificial and formulary distinctions often associated with the form and degree of ownership and focus instead on the essence of the relationship and the linkage between the entities. That linkage must be substantial before the transaction or income becomes apportionable and subject to tax.

A decision upholding the court below would allow the States to impose tax on intangible income without real regard to the connection between the income and the taxpayer's activities in the State. Let stand, then, the Illinois decision would lead to multiple taxation of extraterritiorial income by permitting the apportionability of income based on the most attenuated of relationships. Such a result would eviscerate the Court's teaching in *Allied-Signal*.

ARGUMENT

I. THE IMPORTANCE OF THIS CASE: VIVIFYING THE COMMERCE AND DUE PROCESS CLAUSES

The Due Process and Commerce Clauses of the U.S. Constitution[2] require some definite link, or nexus, between a State and a taxpayer or activity to be taxed. Without such a connection, a State's taxing scheme will be struck down as unconstitutional. This case presents the question of what connection must exist between the State of Illinois and the income of a nondomiciliary taxpayer (Mead) from out-of-state sources or activities (specifically, the sale of another company, Lexis/Nexis) before that income can be apportioned to, and therefore taxed by, the State. In *Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768 (1992), the Court held that when investment income is derived from activities unrelated to the in-state business activities of a unitary business, "due process considerations . . . preclude apportionability [and hence taxation." *Id.* at 780.[3] In sustaining Illinois's effort to tax Mead on the Lexis/Nexis gain, the court below vitiated the Court's holding in *Allied-Signal* and therefore denied Mead the protections accorded by the Commerce Clause.

Under the Commerce and Due Process Clauses of the U.S. Constitution, a State is prohibited from taxing value outside of its borders. Such taxation is

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[2] U.S. Const. art. I, § 8, cl. 3 (Commerce Clause); U.S. Const. amend. XIV, § 1 (Due Process Clause).

[3] "A State may not tax a nondomiciliary corporation's income . . . if it is derive[d] from 'unrelated business activity' which constitutes a 'discrete business enterprise.'" *Id.* at 773 (quoting *Mobil Oil v. Commissioner of Taxes of Vermont*, 445 U.S. 425 (1980)).

proscribed because the "fundamental purpose of the [Commerce] Clause is to assure that there be free trade among the several States," *Boston Stock Exch. v. State Tax Comm'n*, 429 U.S. 318, 335 (1977), and because extraterritorial taxation offends fundamental notions of due process and constitutes an "unreasonable clog upon the mobility of commerce." *Baldwin v. G.A.F. Seelig, Inc.*, 294 U.S. 511, 527 (1935).

To tax the out-of-state income of a nondomiciliary corporation, there must be a "minimal connection between the interstate activities and the taxing State, and a rational relationship between the income attributed to the State and the intrastate values of the enterprise." *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 445 U.S. 425, 436-37 (1980) (quoting *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 273 (1978)). A State may not tax the income of a nondomiciliary corporation—such as Mead here—if the income is derived from business activities that constitute a discrete business enterprise with business operations unrelated to the business carried on in the State. *See Allied-Signal*, 504 U.S. at 780. Indisputably, that is what Illinois is seeking to do here.

II. LEXIS/NEXIS WAS NOT UNITARY WITH MEAD

Petitioner MeadWestvaco Corporation is the successor-in-interest to Mead Corporation, an Ohio corporation, whose principal trade and business is producing and selling forest products, including paper, packaging and paperboard, and school and office supplies. Mead conducted its business in several states, including the State of Illinois. In 1968, Mead purchased Data Corporation, an Ohio-based company whose focus was developing inkjet

printing technologies. Data Corporation was also in the process of developing a computerized full text information retrieval system that, for the first time, used computer technology in legal research. After the purchase of Data Corporation, the computerized full-text information retrieval system became known as Lexis/Nexis.

After its acquisition of Data Corporation, Mead continued its business of manufacturing and selling paper and office products. Lexis/Nexis eventually became the world's premier provider of online legal information.

During the years it owned Lexis/Nexis, Mead treated the company as a business separate and distinct from its paper products business. The two did not share personnel or make joint purchases. They maintained separate headquarters, had no centralized operations, and were not functionally related to each other. The two businesses had different corporate cultures and, in fact, were essentially independent of each other. Simply stated, Mead and Lexis/Nexis did not have a unitary relationship.[4]

In 1994, Mead sold Lexis/Nexis and reported the gain from the sale, on its Illinois combined unitary income tax return, as nonbusiness income.[5] As nonbusiness income, the gain was not apportionable to Illinois and other States.

The Illinois Department of Revenue took issue with Mead's treatment of the transaction, asserting that

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[4] Below, the Appellate Court of Illinois did not review the lower court's decision regarding the lack of a unitary business finding. 371 Ill. App.3d 108, 117, 861 N.E.2d 1131, 1139 (2007).

[5] The transaction was structured as an asset sale.

the gain should have been classified as apportionable business income subject to tax in Illinois (and other States). Mead challenged the Department's classification of the gain. The Cook County Circuit Court agreed with Mead that Lexis/Nexis was not unitary with Mead, but nevertheless held that the gain from the sale of Lexis/Nexis was classified as apportionable business income because Mead's investment in Lexis/ Nexis served an "operational function." On appeal, the Illinois Appellate Court upheld the finding of the trial court. The Illinois Supreme Court declined to review the decision.

III. THE UNITARY BUSINESS PRINCIPLE IS ESSENTIAL TO PREVENTING MULTIPLE TAXATION

In *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450 (1959), this Court confirmed that "the entire net income of a corporation, generated by interstate as well as intrastate activities, may be fairly apportioned among the States for tax purposes by formulas utilizing in-state aspects of interstate affairs." *Id.* at 460. Hence, apportionment formulae are used to determine what part of a taxpayer's income may be properly taxed by the respective States. For example, under the Uniform Division of Income for Tax Purposes Act (UDITPA), the apportionment formula compares (1) the taxpayer's property, payroll, and sales (receipts) within the taxing State to (ii) the taxpayer's total property, payroll, and sales. UDITPA §§ 9-17. The purpose of the apportionment formula is to assign to the taxing State the amount of the taxpayer's total income that is earned in, and therefore is reasonably attributable to, the State.

The general permissibility of formulary apportionment, however, should not obscure the Constitution's limitation on the States' ability to tax out-of-state income. As the Court held in *Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. 159 (1983), "[u]nder both the Due Process and Commerce Clauses of the U.S. Constitution, a State may not, when imposing an income-based tax, 'tax value earned outside its borders.'" *Id.* at 164 (quoting *ASARCO Inc. v. Idaho State Commission*, 458 U.S. 307, 315 (1982)). Consequently, formulary apportionment is permissible only to the extent that the result is a "'rough approximation' of the corporate income tax and is 'reasonably related to the activities conducted within the taxing state.'" *Exxon Corp. v. Department of Revenue*, 447 U.S. 207, 223 (1980) (quoting *Moorman Mfg. Co.*, 437 U.S. at 273-74). *See Wallace v. Hines*, 253 U.S. 66, 69 (1920) (Holmes, J.) (the purpose of apportionment formulae based on values both within and without a State is not "to open to taxation what is not within the State," but only to estimate the true values of the things within in it).

More than a century ago, this Court held that the taxability of a nondomiciliary taxpayer's out-of-state income turned on the application of the "unit rule" or the unitary business principle—on whether the out-of-state item sought to be taxed was "unitary" with, or functionally related to, the taxpayer's in-state activities. *State R.R. Tax Cases*, 92 U.S. 575, 608 (1875). In 1980, this Court encapsulated its prior holdings when it declared in *Mobil Oil Corp.* that the unitary business principle is the "linchpin of apportionability in the field of state income taxation." 445 U.S. at 439. Subsequently, *ASARCO* and *Container*

Corp. reaffirmed the unitary business principle and established standards for determining whether the requisite link exists between a nondomiciliary taxpayer's business activities within the State and its investments in or income from other entities.[6]

In *Allied-Signal*, the Court explained that the "unitary business rule is a recognition of two imperatives: the States' wide authority to devise formulae for an accurate assessment of a corporation's intrastate value or income; and the necessary limit on the States' authority to tax value or income that cannot in fairness be attributed to the taxpayer's activities within the State." 504 U.S. at 780. Under *Allied-Signal*, the Constitution permits the apportionment of income even in the absence of a formal unitary business where the asset (or transaction) in question serves an operational function rather than an investment function. 504 U.S. at 787. The Court explained that the inquiry whether an asset (or investment or transaction) serves an operational rather than investment function—

> focuses on the objective characteristics of the asset's use and its relation to the taxpayer and its activities within the taxing state. It is an inquiry to which our cases give content, and which is necessary if the limit of the Due Process and Commerce Clauses are to have substance in a modern economy.

Id. at 785.

In essence, the Court's operational-versus-investment function rule represents a gloss on the unitary business principle itself, born of the recognition that

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[6] *See also F.W. Woolworth Co.*, 458 U.S. at 364.

in certain circumstances (for example, in respect of venture capital or private equity firms) an enterprise's business operations may be the making of investments in other companies, even if the operations of these investments are not unitary with the enterprise's own operations. *See Adams Express Co. v. Ohio State Auditor*, 165 U.S. 194, 222 (1897) ("while the unity which exists may not be a physical unity, it is something more than a mere unity of ownership. It is a unity of use, not simply for the convenience or pecuniary profit of the owner, but existing in the very necessities of the case—resulting from the very nature of the business.")

Because the trial court found that there was not a unitary relationship between Mead and Lexis/Nexis, barring a recasting of the constitutional rule by the Court, the proper disposition of this case turns on the application of the operational-versus-investment function test.

IV. MEAD'S OWNERSHIP OF LEXIS/NEXIS SERVED AN INVESTMENT, NOT AN OPERATIONAL, FUNCTION

A. The Court Below Ignored the Teaching in *Allied-Signal*

The Appellate Court of Illinois determined that Mead failed its burden of proving "that Lexis/Nexis was not an operational asset," 371 Ill. App. 3d. at 117, 861 N.E.2d at 1139-40, but its analysis betrays a misapprehension of *Allied-Signal*. In reaching this conclusion, the lower court said: "Mead was 100% owner of Lexis/Nexis. Although Mead did not have day-to-day control over Lexis/Nexis, its involvement with Lexis/Nexis was more than merely passive." *Id.* at 118, 861 N.E.2d at 1140. Thus, under the Illinois

court's analysis, investments in all wholly owned companies would be treated as operational assets despite the lack of any unitary relationship between the company and the parent and without regard to why the company was acquired—despite, in other words, the connection required by the Commerce Clause to guard against extraterritorial taxation.

Simply stated, requiring gains from the sale of wholly owned companies, *ipso facto*, to be apportioned without requiring more would distend the unitary business principle that the Court articulated more than a century ago and vivified 15 years ago in *Allied-Signal*. There, the State of New Jersey urged the Court to abandon the unitary business principle and allow nondomiciliary states to apportion (and tax) all of a corporation's income without regard to whether the income has a connection with the nondomiciliary state. *Allied-Signal*, 504 U.S. at 784. This Court rightly rejected this theory as sweeping, citing a 1982 decision that held that the "*potential* to operate a company as part of a unitary business is not dispositive when, looking at 'the underlying economic realities of a unitary business' the dividend income from the subsidiaries . . . [was] derive[d] from 'unrelated business activity' which constitutes a 'discrete business enterprise.'" *F.W. Woolworth Co.*, 458 U.S. at 362 (quoting *Exxon Corp.*, 447 U.S. at 223-24 (emphasis in original)). Likewise, the mere (but not actual) potential to integrate a wholly owned business into the parent's operations, without more, is not enough to justify classifying the ownership as "operational" in nature.

The Illinois Appellate Court also said that apportionment is appropriate because Mead made contri-

butions of capital and "manipulated" Lexis/Nexis's structure by changing its form from a division to a corporate subsidiary. 371 Ill. App.3d at 118, 861 N.E.2d at 1140. It failed to explain adequately, however, how these activities bolstered its conclusion. Increasing the amount of capital invested in a subsidiary may merely reflect an owner/investor's decision that the subsidiary presents a greater opportunity for return than other investment options. Likewise, transforming a wholly owned subsidiary into a division (or vice-versa) may reflect nothing more than a decision how to hold or own an investment. Neither of these owner/investor decisions by itself reflects an operational purpose within the meaning of *Allied-Signal.*

B. The Hallmarks of an Operational Relationship

Whether an asset (or investment or transaction) serves an operational rather than investment function "focuses on the objective characteristics of the asset's used and its relation to the taxpayer and its activities within the taxing state." *Allied-Signal*, 504 U.S. at 785. This prompted the Court to find in *Allied-Signal* that "the payee and payor need not be engaged in the same unitary business as a prerequisite to apportionment in all cases. . . . What is required instead is that the capital transaction serve an operational rather than an investment function." 504 U.S. at 787. Thus, the connection of the asset or the transaction to the *operations* of the enterprise can, where strong enough, operate as a proxy for a formal finding of "unitariness."

Before *Allied-Signal*, the Court focused on the investment-versus-operational issue as part of its unitary analysis. For example, in *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159, 180 (1983), the Court made clear that "capital transactions can serve either an investment function or an operational function," and found that foreign subsidiaries served an operational function as a result of *Container Corp.*'s loans and loan guarantees to these subsidiaries." In *Home Interiors and Gifts, Inc. v. Department of Revenue*, 318 Ill. App.3d 205, 741 N.E.2d 998 (Ill. App. 2000), *appeal denied*, 195 Ill. App.3d 552, 754 N.E.2d 1285 (2001), relying on *Allied-Signal* and *ASARCO*, the court stated that "in deciding whether funds in a short-term bank account serve an operational or investment function, the Supreme Court's decisions . . . confirm that the court must determine how the corporation use[d] the funds." *Id.* at 214, 741 N.E.2d at 1006. The court found that the passive investment income was not apportionable to Illinois "simply because Home Interiors used a small portion of its funds held for investment purposes for its working capital needs." *Id.* at 215, 741 N.E.2d at 1007.[7]

To be sure, the concept of "business-relatedness" is neither uniform nor susceptible to definitional precision. Beyond the three broad *unitary* themes of functional integration, centralization of management, and economies of scale, *Mobil Oil*, 445 U.S. at 438,

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[7] *See* 1 J.Hellerstein & W. Hellerstein, *State Taxation: Constitutional Limitations and Corporate Income and Franchise Taxes* ¶ 8.09[5][b][i], at S8-13 (3d ed. 2000 and 2006 Cumulative Supplement No. 2) (discussion of "thoughtful opinion" in *Home Interiors* distinguishing mere availability of capital from its actual use).

the following external and internal factors are indicative of an operational relationship:

Externally:

- Do the businesses at issue naturally fall within the same industry or industry segment?
- Do they share the same or closely similar customer bases?
- Do they share common marketing, advertising, and branding strategies?
- Do the businesses share common inputs, *e.g.*, infrastructure, sources of supply, and raw materials, as well as common outputs, *e.g.*, distribution channels, maintenance, support, and warranty mechanisms?

Internally:

- Do the businesses share services, *e.g.*, administrative or strategic?
- How have the respective strategic business plans been substantively developed?
- Are the business decision-makers who are involved in those processes and accountable for business results the same or different?

These criteria transcend the sometimes artificial and formulary distinctions often associated with the form and degree of ownership and focus instead on the essence of the relationship and the linkage between the entities—a linkage that must be substantial before the transaction or income is to be deemed apportionable and subject to tax.

Amicus TEI regrets that—absent the imposition of other, arguably more administratively burdensome and intrusive limitations—the distention of the operational-versus-investment test could eviscerate the protections of the unitary business principle and

thus convert the potential for duplicative taxation into reality. And given the Court's historical reluctance to dictate the specific components of a given State's allocation and apportionment scheme, *Moorman Mfg.*, 437 U.S. at 278-80, the development and imposition of such limitations are not guaranteed. A decision upholding the court below would allow the States to impose a tax on intangible income, without real regard to the connection between the income and the taxpayer's activities in the State.[8]

In short, the existence of an operational relationship cannot, as the Illinois Appellate Court seeks to do, be premised on shibboleths—code words extracted out of context and contorted to mean only what the State, like Humpty Dumpty in *Through the Looking Glass*, wants them to mean.[9] Instead, that determination must be grounded on characteristics of the business relationship that reveal the substantive nature of that relationship. Thus, if the core activity of an enterprise is the buying and selling of companies (*e.g.*, if it is a venture capital, buy-out, or private equity firm), then the money derived from the making of investments in its "targets" may properly be viewed as "operational" under *Allied-Signal*, even though the business of targets was never integrated into or made unitary with, the enterprise itself. That

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[8] A decision upholding the court below would not *require* all the States to apportion such income, only *free* them to do so, unfettered by the limitations inherent in the unitary business principle. At the same time, the State of commercial domicile would presumably retain the right to allocate the same income, thus raising the specter of multiple taxation.

[9] Lewis Carroll (Charles L. Dodgson), *Through the Looking Glass* ch. 6 (1865) ("'When I use a word,' Humpty Dumpty said, in a rather scornful tone, 'it means just what I choose it to mean—neither more than less.'").

situation, however, is completely different from the case here where Mead (a paper products company) invested in Lexis/Nexis.[10]

Let stand, the Illinois decision will lead to multiple taxation of extraterritorial income by permitting the apportionability of income based on the most attenuated of relationships. Thus, the situation is not much different from when the Court stanched the effort of New Jersey in *Allied-Signal* and vivified the unitary business principle. Accordingly, the Illinois decision below was erroneous and should be reversed.

CONCLUSION

For the foregoing reasons, the decision of the Appellate Court of Illinois should be reversed.

Respectfully submitted,

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[10] See 1 J. Hellerstein & W. Hellererstein, *supra*, ¶ 9.11[1][c], at 9-99 (if a company "was in the business of buying or selling other businesses, the stock of [those] other corporations surely served an 'operational function' in its business.").